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"Though I believe that recurring business depressions can only be explained by the operation of our monetary institutions, I do not believe that it is possible to explain in this way every stagnation of business. This applies in particular to the kind of prolonged depression through which some European countries are passing through today."

Friederich A. Hayek, Prices and Production, p.111
London, George Rutledge & Sons, 1931

HIGHLIGHTS

All available data suggests that the economies of the deficit countries have fallen into a deep recession that touches virtually every part of the spectrum: retail sales, services, construction, production, capital spending and employment. The signs of trouble are everywhere.

Woefully few economists in these countries understand the causes of this downturn. They all mistakenly judge the current situation from the framework of an average post-war business cycle.

In the U.S., literally not one single precursor of a typical post-war recession can be seen. No wonder the mathematical radar screens failed to pick up any signs of an approaching recession.

Foreign capital inflows prolonged the expansions in the deficit countries through two effects: first, capital imports added to the buying power of the deficit countries; and second, the resulting large excess of imported goods suppressed and "camouflaged" underlying domestic inflation.

The most significant aspects of the deficit countries that determines their future outlook is that they have experienced the longest and biggest credit inflations in their history, spreading distortions right across their economic and financial systems.

In early 1990, a great tide change began for consumers. The unpalatable, mostly ignored truth is that a sharp cutback in real consumer spending has a cause that's far more real than an imagined confidence shock triggered by the Gulf crisis — namely, a ferocious income squeeze.

This income squeeze now merges with a deflation of the consumer's borrowing binge. It should be realized that this is a highly dangerous economic mix. A debt squeeze and an income crunch now reinforce each other.

How long and deep will the current recession be? The most important point to grasp is this: instead of being a self-limiting, self-correcting, inventory-liquidation recession, this downturn is being driven by a self-reinforcing, income-debt spiral that has overheated and gone critical.

The parallels with the 1930s are most striking both in magnitude and in the pattern of the financial excesses. All in all, there is virtually nothing in sight that might reverse the current slump in the U.S. economy.

(Editors Note: Our interpretation of the economic evidence for some time has pointed to the serious risk of a downturn for a number of countries, particularly the United States. The Middle East Crisis, although it indeed appears very grave as we write, has become all too convenient a scapegoat for the downturn. A critical dependent question, then, is how much attribution can be given to the Gulf situation in influencing recent economic trends. In this letter we review and reconfirm the answer to the disputed but pressing question of whether the U.S. recession will be "short and shallow" — as the consensus currently believes — or severe and prolonged. It commands first rank in framing investment expectations.)

INTO THE DEBT PINCER

After all the denials, there's no more denying. The evidence is irrefutable: America is in a recession. However, the U.S. is not without company. The economies of all the major English-speaking countries — Britain, Canada, Australia, New Zealand — and also Sweden and Finland have turned downward with a vengeance. Almost one third of the world economy is now mired in recession.

All available data suggests that these economies have fallen into a deep recession that touches virtually every part of their economy: retail sales, services, construction, production, capital spending and employment. The signs of trouble are everywhere.

Observing the general responses to the stream of depressing economic news surfacing during the past months we note a striking contrast between the sentiment of ordinary consumers and the "professionals" — mainly money managers and government, business, and financial economists. It might have been supposed that investors and professional economists should be the first to recognize that unprecedented financial woes pose the significant risk of a deeper recession. However, it's the consumer and not the financial community who appears most agonized. According to various surveys, U.S. consumer confidence has virtually collapsed, suffering the sharpest six-month drop in history.

In contrast, most economists have only shifted their forecasts moderately, moving from a "no recession" stance to that of a mild recession. Until a few months ago, conventional wisdom was that the slowing economy would avoid a recession. Now, after the recession stares into the face, they have quickly decamped and retreated to the comfortable conclusion that it will be milder and shorter than usual.

Judging by the record cash inflows of equity mutual funds, obviously, quite a few individual investors must share the sanguine view of their professional mentors. Despite generally falling share prices, sales of equity funds exceeded redemptions during the first 11 months of 1991 by $23 billion. Including reinvested dividends, more than $60 billion of new money was poured into equity funds, up from $54.5 billion in 1989.

To be sure, Wall Street and the financial community are still a long way from sharing the consumer's gloom and doom. Deep down inside they are still highly constructive on the prospects for stocks and the U.S. economy . . . never mind a few odd grizzly bears who draw attention to the developing parallels of 1929-30. Most appear enthraled by the widely publicized observation that all bull markets have been born in the depths of recession and seem more concerned about missing the next breeze of a market rally than avoiding a tempest of a shake-out.

It is an undisputed fact that reckless speculation — largely in the form of corporate takeovers and leveraged buy-outs — propelled U.S. share prices to grossly overvalued levels. So far, the Dow Jones Industrial Average and the broader based S&P 500 are off only 12-13% from their respective all-time inflated highs, much less than the average bear market experience. Understandably, notorious bulls, who saw nothing wrong with the economy and had entertained visions of sugarplum fairies and the Dow at 5000, may be shocked by this decline. In relation to the rapidly deteriorating economy, though, the markets have been grossly lagging the reality of a skidding economy.

A QUEST FOR THE REAL CAUSES

To us, the tell-tale signs of a severe and prolonged economic downturn in America and other countries have long been evident. Now, as the downturn finally invades the consciousness, an urgent and essential question must be addressed quickly: What is the true cause and nature of the current downturn? Only from the perspective of an accurate assessment of that question can one correctly address the issue of whether it will be short and shallow or deep and long.

What's shallow so far is the quick denial of the worst outcome at official levels. Like "voodoo" economics, the emphasis is all on expectations and none on the material fundamentals. Gauging from all the "upbeat" pronouncements by government officials, the psychological impact of admitting to a recession and mouthing the word is seen to be more detrimental than the economic reality of the situation. That tendency to smother negative facts in sweet syrup is evident in this quote of a prominent economist carried in the New York Times (December 29, 1990): "*[Economists] may have been thinking about the relationship between what they say and what the world does, in which case, discreet silence would have been better.*"

Yes, private economists have beaten a hurried retreat from their "no recession" stance to "mild recession" but, typically, any reasons they see lie outside the realm of the economy itself. We order the favourite explanations of American economists for the current recession as follows:

1. First, that Saddam Hussein's oil price shock has shattered consumer confidence and has caused everyone — consumers, corporations and banks — to batten down the hatches at the same time;

2. That Alan Greenspan and the Fed has been too slow in loosening the monetary brakes;

3. And, that overzealous bank examiners have been battering bank balance sheets, thereby squeezing bank lending.

All three supposed causes have one attraction in common: they are superficial. The war, if it occurs, will be over soon, or a negotiated settlement is inevitable, or Greenspan and the bank examiners will ease up . . . etc..

Even Mr. Greenspan, the Fed-Chairman, has argued that the "soft landing economy" of 1990 could have escaped recession were it not for the spike in oil prices and the confidence-crushing uncertainty triggered by Hussein's seizure of Kuwait.

To us, all these arguments confirm the point we stressed in the last letter. Woefully few American economists understand the causes of this crisis. The crucial mistake they all make (and this even includes many of the bearish forecasters) is that they judge the current situation from the framework of an average business cycle of the last 40 years.

To the say the least, the first two of the above three explanations are more than just hollow. They are plainly ludicrous. Shouldn't one wonder why it's only the Anglo-Saxon countries that have come to such sudden grief from the Middle East crisis and the oil-price hike while the rest of the world shows little or no adverse impact? Even more ironic is the fact that at the onset of the Gulf crisis the reverse viewpoint was generally argued. It was expected that America, Britain and Canada — given that they were oil producers — would be the least affected as compared to countries like Germany and Japan which have to import all their oil requirements.

And what about Mr. Greenspan being too restrictive? Maybe he is. Yet, the salient fact is that America has the lowest interest rates in the world, both nominally and real (see table on following page). The German economy, for example, is booming despite 6% real interest rates while the U.S. economy is sliding into recession. What is the matter with the U.S. economy that it's unable to bear even these internationally-low rate levels?

Before we delve into a more detailed rebuttal of these popular viewpoints, let's first take stock of the crucial data for the major countries as outlined in the table on the facing page.

THE FALL OF CONFIDENCE: FUNDAMENTAL FACT OR PSYCHOLOGICAL FICTION?

Is it likely that the Gulf crisis was so shocking that it stampeded an overreaction and therefore explains the collapse of consumer and business confidence? For this explanation of the sharp downturn in consumer spending to make any sense, you have to assume that the "shocked" consumer suddenly spent much less of his income and piled a larger chunk into savings. The trouble with this explanation is that the facts don't bear up. Precisely the opposite has happened. Actually, the consumer spent increasingly more of his current income and saves less and less. Personal savings fell from $195.1 billion in the second quarter of 1990 to $164.7 billion in the third quarter and $151 billion in October (all in annualized terms). As such, the savings ratio slipped from 5% in early 1990 to well below 4% recently.

The unpalatable, mostly ignored truth is that the sharp cutback in real consumer spending has a cause that's far more real than an imagined confidence shock — namely, a ferocious income squeeze. Real disposable income — what's left after inflation and taxes — stopped growing in the second quarter and specifically started to decline in July. Disposable income probably plunged at an annual rate of at least 4.5% in the fourth quarter. Far from retrenching though, it seems the consumer drew on his savings to maintain his spending. The real important question, then, is what are the causes of this income squeeze. Actually, they're rather easy to see and include two familiar reasons and a third one that's new.

The first familiar cause of the income squeeze is zero productivity growth and the second is that price inflation is rising faster than wage rates. The final knockout blow to the consumer, though, has been

the sputtering out of the legendary U.S. job-producing machine. Services and manufacturing businesses have embarked on a massive job cutting campaign.

Over the last six months, U.S. job losses have exceeded one million compared with the almost 3 million job gains for all of 1989. Plainly, this dramatic reversal in employment is the key reason for the precipitous decline in U.S. economic activity.

COMPARATIVE ECONOMIC STATISTICS
(% Change at Annual Rates)

	Industrial Production		**Real GNP**		**Real Retail Sales**	
	3 mos	1 yr	3 mos	1 yr	3 mos	1 yr
USA	-4.3	-0.6	1.4	1.0	-3.6	-1.7
Britain	-9.2	-1.5	-4.0	0.5	-4.6	-0.8
Canada	-5.9	-2.8	-1.0	0.5	-1.1	-4.1
Germany	7.9	6.1	6.8	5.5	15.3	7.7
France	0.4	1.1	5.3	3.0	-5.9	2.4
Japan	7.3	8.2	4.1	5.4	1.9	7.5

	Consumer Prices		**Interest Rate Differentials Versus Dollar (Euro-market)**
USA	8.3	6.3	
Britain	8.7	9.7	+ 6.24%
Canada	5.1	5.0	+ 3.77%
Germany	2.8	2.7	+ 2.10%
France	5.5	3.6	+ 2.99%
Japan	8.1	4.2	- 0.76%

Source: The Economist, Economic and Financial Indicators, Financial Times

Now to the all encompassing root question: Why these drastic job cuts? The few American economists who bother to address this question tend to resort to their universal explanations for just about everything: confidence and expectations. Why have businessmen suddenly turned from massive hiring to massive firing though final demand appeared to hold up well, at least until the third quarter? The optimists' fundamental argument is that the drastic production and job cuts have been prompted more by a "precautionary" shock reaction than a response to any collapse in demand.

The simple conclusion, then, is that if consumers and businesses have overreacted to an event which will soon be settled one way or another, then confidence will recover rapidly and so will demand. And given that inventories are lean the final deduction is too comforting to pass up: the U.S. recession will be the shortest and shallowest on record.

FROM PROFIT SQUEEZE TO INCOME SQUEEZE

In reality, though, it is easy enough to recognize a totally different yet far more direct and rational reason for this savage job cutting. This reason makes daily headlines in the financial press of the various recession countries. It is a "profit squeeze"; a widespread, truly savage profit crunch. Keynes once said: *"Profit is a small thing. But take it away, and everything stops."*

All too obviously, American business is slashing employment in a desperate effort to arrest its rapid profit decline. The drastic job cuts in turn translate into a correspondingly rapid decline in consumer incomes and consumer spending.

Business profits typically shrink in late expansions under the pressure of tight money as businesses fail to pass through sharp cost increases in this stage. Normally, this profit weakness sets in a few quarters before the real GNP peak and lasts more or less until the economy finally hits bottom. This time, though, the customary profit squeeze that unfolded was unusually early and sharp. According to a study by Goldman Sachs, after-tax profits adjusted to exclude inventory profits fell steeply in the third quarter to a level of $156.7 billion as compared to $178.9 a year earlier and $207.5 billion in the fourth quarter of 1988. That, by far, is the steepest profit decline ever before a recession has started.

Not only does the profit picture portray a grim story, businesses have also insisted on maintaining or raising dividends at the expense of retained profits. This buffer has fallen to record lows. It's undeniable that Corporate America is in its worst shape ever financially, which in our view, is the most plausible and most logical reason explaining the slashing of the workforce with such uncommon speed and at such an early stage.

Far from pointing to "the shortest and shallowest recession on record," this interaction of a profit and income squeeze conjures up the serious risk of a cumulative downturn feeding on itself in a classical depression style; cost cutting leading to flagging demand, which further depresses output, employment and incomes.

How did the U.S. and other countries get themselves into the risk of such a vicious circle, and secondly, how will they get out of it? As we have already mentioned, the United States is not alone in this state of circumstances. Most striking are the parallels in Britain, Canada and Australia and to a point, also in Sweden, Italy and Spain.

THE DEBTOR-DEFICIT COUNTRIES

What, then, is it that sets these recession-prone countries apart from all the others? All these countries have one common fundamental failing: years of runaway money and credit growth. In other words, all of these countries — in striking contrast to Germany and most Continental European countries — have in past years drunken heavily from the intoxicating fountain of credit inflation and debt-fuelled expansion.

In the United States, the credit and debt expansion ran at a rate of 14-15% per annum for years, and in Britain, Canada and Australia at rates of even 20-25% — all against a background of collapsing savings. Such rampant credit inflation, however, didn't alarm anyone because price inflation remained subdued compared to the experience of the 1970s. Financial markets and most economists took this phenomenon as a symbol of underlying economic health thus permitting and fostering the longest peacetime expansion of the post-war period, irrespective of unprecedented deficits and collapsing savings.

This widespread perception that the longevity of the worldwide economic expansion in the 1980s reflected economic health is in reality the cardinal error behind the prevailing complacency. It reflected just the opposite. Virtually unlimited and unconditional international credit financed and permitted unprecedented imbalances and excesses. As capital and credit flooded from the low-yielding currencies of the surplus countries into the high-yielding deficit countries, their grossly imbalanced and ill-structured expansions were prolonged far beyond the cyclical norm.

THE CRUCIAL ROLE OF INTERNATIONAL CAPITAL INFLOWS

Foreign capital inflows prolonged the expansions in the deficit countries through two effects: first, capital imports added to the buying power of the deficit countries; and second, the resulting large excess of imported goods suppressed and "camouflaged" underlying domestic inflation.

Instead of sliding into recession under the pressure of accelerating inflation and soaring interest rates as in past cyclical upswings, the deficit countries seemed to be blessed with the best of all worlds: booming economies, strong currencies, low inflation, buoyant financial markets and rising life styles. Unfortunately, there's no such durable miracle. It all rested on booming borrowing and lavish lending.

The essential point to see is that in the absence of these huge international capital flows, the expansion in all the deficit countries would have been aborted years ago. It is only in that sense that the international borrowing and lending binge of the 1980s seemed to have had a beneficial effect. But at what cost? When all is said and done, it will have been an untenably high price.

The economic costs always arise from the fact that the longer the credit and debt excesses perpetuate, the geometrically greater are the economic and financial maladjustments that are left in the wake. Gauging from the record length of this last expansion, it will be a capsizing wake.

During past business cycles, excess money went mostly into producer and consumer prices. That vented inflationary pressures into consumer prices. Not only that, any modest deterioration in the trade balances tended to alarm the currency and credit markets forcing the central bank of the overheated deficit country to hit the monetary brakes at an earlier stage.

As a result, cyclical upswings generally lasted no longer than 3-4 years. These short cycles had one great advantage: they limited the scope for financial excesses and real maladjustments. The usual features of overextension were inventory build-ups and some overbuilding associated with rising price indexes which triggered the monetary tightening. Correcting these two major maladjustments generally didn't take much more than a year.

THE CARDINAL ERROR

During the post-war period, the United States experienced eight cycles and recessions, all of which fitted this pattern described above. The present ninth recession is the first one in this period that radically deviates from the prototype. No bottlenecks preceded this downturn. There was no inventory build-up and no dramatic surge in wages and prices that forced the Fed to clamp down.

On the contrary, the Fed has already been lowering interest rates since mid-1989 and therefore there was also no classical inverted yield curve.

Literally not one single precursor of a typical post-war recession is to be seen. No wonder the mathematical radar screens of American economists failed to pick up any signs of an approaching recession. In particular, it's the "low" and "stable" inflation rates that speak so deceptively that the current recession will be only "short and shallow" and that the economy is fundamentally healthy. From the viewpoint of the traditional German-Austrian school, though, this is a cardinal error.

Rule #1 for any adherent to the traditional Austrian-German school is to look at the rate of credit expansion and not to just simply glance at the sometimes faulty instrument of price indexes. It's true that inflation mostly expresses itself in the rising prices of goods and services. However, the real essence of inflation is a credit expansion in excess of domestic savings. Depending on the circumstances, such a "credit inflation" may find its outlet in very different spectrums of the economic, financial and price system without affecting the normal price indexes which relate only to the prices of goods and services.

Basically, every recession is the fallout from the excesses that have accumulated during the prior boom and is the unwinding process. Under the impression of the World Depression of the 1930s, Gottfried Haberler hypothesized in his book commissioned by the United Nations, Depressions and Prosperity, *"The length and severity of depressions depend partly on the magnitude of the "real" maladjustments which developed during the preceding boom and partly on the aggravating monetary and credit factors."*

PRIME REALIZATIONS

In trying to access the risks of a severe recession in America, Britain, Canada and Australia the first thing to realize is that these countries have experienced the longest and biggest credit inflations in their history. That's one loaded point to consider. The other one is that their credit inflations have been much more widely dispersed than in prior cyclical booms. This time the effects were spread right across the economic and financial system thus causing far more dangerous imbalances and maladjustments than just inventories.

As such, the task is now to identify those areas in the whole production and price structure that have been materially inflated by the borrowing excesses. It is these credit-bloated areas that are bound to take the worst beating in the impending recession as the credit expansion begins to normalize.

THE WEAK LINKS

There are four obvious areas where painful adjustment must still be expected in all the Anglo-Saxon countries.

> **Stock Market.** The most spectacular case is the U.S. stock market boom. It was driven by U.S. corporations borrowing around $1.7 trillion to finance takeovers, leveraged buy-outs and stock repurchases that together massively inflated stock prices.

Real Estate. Overinvestment — largely malinvestment — occurred in commercial real estate and also residential real estate in some areas. For example, almost 45% of all the office space ever constructed in the U.S. took place in the 1980s.

Consuming Spending. Consumer outlays were heavily inflated through instalment credit and, since 1986, even more by soaring home equity loans (when the Tax Recovery Act maintained the deductibility of interest expenses on homes while eliminating the same on personal loans). Between 1986 and 1989, the annual increase in home mortgages has averaged $225 billion. That was double the $112 billion average during the preceding four years.

In these four years, total U.S. consumer debt swelled by an unbelievable $1.2 trillion. This compares with a coincident increase in current disposable income of $887 billion in current dollars.

Trade Imbalances. Last but not least, rampant inflation found its outlet in the soaring trade and current account deficits of these countries. Part of the problem, apparently, was that the soaring trade deficits suppressed underlying domestic inflation.

CONSUMERS CHANGE DIRECTION

In early 1990, a great tide change began when household borrowing started decelerating dramatically despite a monetary easing. While economists may argue over the underlying cause, the fact is that this decline began in early 1990 well before the Gulf Crisis.

Not only that, this deflation of the consumer's borrowing binge has now merged with the ferocious income squeeze that we already documented earlier. Higher inflation rates and sliding employment take their toll on the consumer's current disposable real income. As household borrowing and spending declines, incomes automatically decline, and vice versa, adding up to the drastic contraction of consumer demand that has pulled the bottom from under the economy in the fourth quarter of 1990. **A debt squeeze and an income crunch now reinforce each other.** Financial stress intensifies exponentially simply through the relentless force of compound interest.

Coming back to the question of how long the current recession will last, the most important point of all to grasp is this: instead of being a self-limiting, self-correcting, inventory-liquidation recession, this downturn is being driven by a self-reinforcing income-debt spiral that has finally overheated and gone critical.

And what of business liquidity? Is it improving? Of course not. It continues to deteriorate at an accelerating pace as profit and cash flow declines broadly and sharply. As one enterprise after the other cuts costs and tries to dump assets to lighten debt burdens, they only succeed in depressing income and asset prices further.

All in all, there is nothing in sight that might reverse the slump in the U.S. economy.

To be sure, this pattern of inflationary boom and bust has no precedent in the post-war period.

Nevertheless, it has its precedents in history. The most infamous, of course, is the boom of the 1920s that caused a World Depression.

ECHOES OF THE 1930s

The parallels with the 1930s are most striking, both in magnitude and in the pattern of the financial excesses. The 1920s, just as the 1980s, were an era of strong international lending. Borrowing mainly had the effect of pushing up asset prices, particularly in the stock and property market. Also, just as in the past decade, the financial scene was dominated by corporate leveraging though the special techniques differed.

A further important parallel was the inordinate consumer borrowing which fuelled a consumption boom. In the end, widespread overindebtedness led to a debt crisis that turned a recession into a depression as many millions of people saw their savings disappear into the black holes of thousands of failing banks.

No less striking were the parallels in the economic debates. In both periods there was the same talk of a "New Era" of eternal prosperity with no recession, which, in both cases undoubtedly encouraged the phenomenal financial excesses. Then, as today, there was a complacent attitude towards the soaring indebtedness.

Economists could never agree as to what caused the Depression of the 1930s. In the main, it started with the stock market crash of late 1929 and a sudden large fall in consumption in 1930 which played a key role in depressing the economy. Yet, today it remains unexplained as to what triggered these two events. Certainly, however, the blame cannot be apportioned to any pessimism among businessmen, consumers and forecasters. To all those who attribute the present economic downturn in the Anglo-Saxon countries to no more than a quixotic loss of confidence, it may be mentioned that the depression of 1929/1930 unfolded in a climate of great optimism which faded only very slowly.

In a recent issue, the London Economist evokes the title "Echoes of the 1930s." Unfortunately, the article fails to address — much less investigate — the key question. It concerns the key difference between a debt crisis and a liquidity crisis.

Under the influence of Milton Friedman it became the consensus view in America that the prolonged U.S. depression originated mainly from a collapse in the money supply which was caused or permitted by the faulty policies of the Fed. Friedman was convinced he had proven beyond any doubt that economic fluctuations were principally caused by the preceding changes in the money supply. The fact is, though, that his weakest case in this respect is the 1930s Depression. In the United States the progression ran in reverse. The economy plunged first in 1930-31 and the money supply slumped later in 1932-1933. Quite to the contrary, this rather unusual sequence raised the question of what could have caused this abnormality.

In diametrical contrast to the views of American economists, the leading Austrian and German economists of that time always stressed the causal link between the extraordinary financial excesses of the 1920s and the extraordinary depth of the depression that followed in the 1930s. Haberler's

quote on page 8 reflects the same concept. Unrestrained credit expansions artificially buoyed stocks and real estate prices; credit retraction drove down prices with equally shattering speed.

As already elucidated in the last letter, our explanation and point of focus centres on the two main culprits: first, the credit excesses during the boom which led to dangerous overindebtedness; and second, the distortions in the price and production structure. Neither of these two issues finds any mention in the 850 pages of Milton Friedman's Monetary History of the United States.

A quote from Joseph A. Schumpeter's Business Cycles provides a sharp contrast: "*Given the way in which both firms and households had run into debt during the 1920s, it is clear that the accumulated debt load was instrumental in precipitating depression. In particular, it set into motion a vicious spiral within which everybody's efforts to reduce that load for a time only availed to increase it.*"

Some of the facts of that era have more than a passing similarity. Between 1925 and 1929, U.S. nominal GNP grew by $10.2 billion from $83.4 billion to $93.6 billion. Total debts, on the other hand, increased $28 billion from $163 billion to $191 billion. Each dollar of incremental GNP was financed by $2.80 of additional debt. In the period between 1945 and 1980, this same debt-GNP ratio fluctuated narrowly around $1.30. Each new dollar of GNP was complemented by the addition of $1.30 to net debt.

And what of the recent boom period? Between 1982 and 1989, U.S. nominal GNP rose by $2.21 trillion. Total indebtedness of the non-financial sector grew by $5.23 trillion resulting in a GNP-debt ratio of $2.36. As we said, the parallels are more than striking.

SUMMARY CONCLUSIONS

In conclusion, we again come back to the important question of the length and depth of the impending U.S. recession. We have substantiated in detail why we think that it is absolutely inevitable that America and other countries in similar situations will face a long and deep recession.

How do the optimists substantiate their rosy forecasts of a "short and shallow" recession that's to be followed by a new economic recovery by mid-year? Well, they don't. The one and only explanation they proffer is the average cyclical calendar and not one single word as to how a revival in the economy is to be stimulated. In their view, all that's required to pave the way for the next borrowing and lending binge is a bigger dose of easy money and more forgiving bank examiners.

One expectant argument for a recovery is that a recession ensures lower inflation and therefore leaves ample room for stimulatively lower interest rates. Proponents of this argument make a grievous omission. A declining inflation rate due to increased efficiency and lower costs would indeed be beneficial. However, lower inflation due to falling profits is a disaster. Lower inflation brought about in this manner is depressive, not stimulative.

A key distinction of this current downturn goes completely unrecognized. There is no scope for a self-healing, self-correcting liquidation process as is typical of the more usual inventory recession. This downturn is being mainly driven by a self-reinforcing, income-profit-debt spiral.

It all reveals a truly frightening naivety. A central bank can liquefy banks (though only in terms of reserves), however, it cannot liquefy the many corporations and households whose already depleted liquidity is being battered by shrinking cash flow and income and plummeting asset prices. Clearly, financial stress is spreading and intensifying all over.

Not only are U.S. corporations and households much deeper in debt than ever before, the budget deficit is out of control and is on its way to $300-400 billion. In the meantime, personal savings trend lower and are now down around $150 billion. That's by far the worst balance ever between savings and the budget deficit. Ultimately, this is the surest recipe for inflation, but definitely not recovery.

For good reason, attention is focused on developments in the United States. However, Britain, Canada and Australia show the same distinct recessionary tendencies. At the same time, there are tentative signs of slowing demand growth in Continental Europe and Japan with only Germany performing as strongly as expected as unification boosts overall demand.

All in all, the overriding risk shaping up for the world economy is a longer-running recession. As explained, we don't see how the Anglo-Saxon debtor-deficit countries will recover from the cumulative damage, excesses, maladjustments and imbalances embedded in their economies that resulted from prior reckless policies.

Yet, we don't expect a world depression like that of the 1930s. There is one great contrast: sound policies have turned Europe into an island of stability.

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